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**THE EUROPEAN SOCIAL MODEL: LESSONS FOR  
DEVELOPING COUNTRIES**

**by**

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# **The European Social Model: Lessons for Developing Countries\***

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## **Abstract**

Developing countries, in particular the least developed ones, probably have more to learn from social policies in Europe during the early 20<sup>th</sup> century than from the elaborate welfare-state arrangements after World War II. In addition to macro-economic growth and stability, the main ambitions must be to fight human deprivation, including illiteracy, malnutrition, poor access to water and sanitation – and, in some cases, also weak, incompetent and/or corrupt governments. It is also important that informal systems in the fields of transfers and social services are not destroyed when developing countries embark on more formal systems in these fields in the future. The European experience also warns against the creation of social systems that are so generous that disincentives, moral hazard and receding social norms seriously distort the national economy, including the labor market.

**JEL-codes:** H5, I3

**Keywords:** Welfare state, social policy, developing economies

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## 1 General Lessons

In the early 20<sup>th</sup> century, many European countries still relied heavily on the family both for income protection and personal (“human”) services, such as child care and care for the elderly, and, to some extent, also for health care. Civil society, including so-called “friendly societies”, also contributed to income insurance, for instance in connection with sickness, old age, and unemployment (the latter often with the help of union-run insurance systems). Occupational pensions also played an important part for government employees. Besides this, government-created social arrangements consisted mainly of selective poverty relief (social assistance) and basic services in the fields of elementary education and health. In the late 19<sup>th</sup> and early 20<sup>th</sup> centuries, legislation was, however, also introduced for work injury compensation and basic, though quite modest (lump-sum or means-tested) pensions. In some countries, mainly on the European continent, the government was also involved in the organization of occupational pensions in the private sector, primarily in the case of large industrial firms.

Comprehensive systems for income maintenance—in the case of childbirth, single motherhood, unemployment, sickness, old age, etc.—were not introduced in Western Europe (henceforth “Europe”) until the first decades after World War II, however. Secondary and tertiary mass education and comprehensive health care for the entire population were built up at about the same time. It is thus only from the 1960s and 1970s that it makes sense to talk about a “welfare state” in Europe. In other words, Europe was already quite rich, as compared to most contemporary developing countries, when elaborate welfare-state arrangements were created.

Since welfare-state arrangements differ among European countries, talking about a common “European social model” is somewhat misleading. Naturally, this observation constitutes the background to the habit among scholars to classify European countries in terms of different “welfare regimes.” The most important difference among countries probably concerns the relative role of the state, the family, and the market for the provision of income protection and social services. Countries also differ in terms of the relative roles of “universal” benefits tied to citizenship, occupational benefits tied to work, and selective means-tested income support. There is also a considerable difference in the generosity of benefits and welfare services.

As a result of the far-reaching social reforms after World War II, the social arrangements in Europe are today clearly more comprehensive than in other parts of the world. The *achievements* of these arrangements are well known: high-income security for the individual over the life cycle, considerably mitigated poverty, and ample provision of various types of social services. The *weaknesses* of these social arrangements are also well known today. It turned out that some of these arrangements were not very financially robust to various types of shocks, for instance, in terms of demography, productivity growth, and macroeconomic disturbances. The architects of the welfare state also neglected, or at least underestimated, undesirable behavior adjustments in response to changes in economic incentives, as a result of explicit and implicit marginal tax wedges and “moral hazard” in connection with various benefit systems.

What, then, are the general lessons for developing countries of social policies in Europe? These countries, in particular the least developed ones, probably have more to learn from social policies in Europe during the early 20<sup>th</sup> century than from the elaborate welfare-state arrangements after World War II. The reason is, of course, that economic resources, socioeconomic structures, and informal welfare arrangements in the earlier period were more similar to the situation in today’s developing countries than contemporary conditions. In most developing countries, trying to imitate contemporary welfare-state arrangements in Europe would be a serious mistake. In particular, this would be the case for transfer payments designed to provide protection against income losses for the population as a whole, since such protection is very expensive and also requires a highly developed administration. Instead, it is reasonable to give priority to the creation of an environment conducive to entrepreneurship, long-term economic growth, basic health and primary and (at least in some developing countries) secondary education—as was the case in Europe a century ago. The “fine tuning” of welfare-state arrangements in Europe today are often far from what is needed in developing countries. We have also learned how important macroeconomic stability is for social conditions. In addition to macroeconomic growth and stability, the main ambitions must be to fight human deprivation, including illiteracy, malnutrition, poor access to water and sanitation, and, in some cases, also weak, incompetent, and/or corrupt governments.

It is also important to look at social policies in a broad context, and then identify the interaction among different types of economic and social variables. Myrdal (1944, appendix 3) often emphasized processes of “cumulative causation”, with vicious circles among various poverty-creating forces: malnutrition damaging health, which in turn results in social exclusion and reduces the possibilities of acquiring education, which further lowers productivity and political influence, which goes back to square one by exacerbating malnutrition and social exclusion, etc. Dynamic processes of this type are well understood today among professional observers of poverty in developing countries. It is equally important to understand such processes when we try to turn vicious circles into virtuous ones.

There are, of course, other important similarities among developing countries than their poverty. Most of these countries are also rural, and they have a young population. It is, however, also important to emphasize their *differences* in terms of socioeconomic conditions, administrative capacities, the role of informal welfare arrangements and economic and social policies. Presumably, the most important difference is the level of development and the degree of “modernization” which, to a considerable extent, is a result of the governments’ past emphasis on, or neglect of, long-term economic growth. For instance, governments and ethnic and social groups in some developing countries, not least in Africa, have clearly been more engaged in power struggles and rent seeking than in growth enhancing policies. In several South East Asian countries, by contrast, it is fair to say that concern for economic growth has indeed dominated, also over issues of income security. As we know, this has been reflected in a heavy emphasis on capital formation. Some of these countries have, however, also succeeded in combining fast economic growth with a fairly even distribution of income and wealth, thanks to early land reform and widespread elementary education. The emphasis on economic growth also shows up in the composition of infrastructure investment, which has been heavily concentrated on production-oriented structures such as harbors and roads and railways, rather than facilities directly servicing households, such as housing, sanitation and the environment in cities and the countryside. This emphasis on growth, of course, reflects an understanding among policymakers that mass poverty can never be replaced by mass affluence without sustained economic growth during many decades.

This said, we should not forget that some social arrangements, not just spending on primary education, might be conducive to long-term economic growth, the most

important examples perhaps being policies improving the nutrition status and the general health conditions of the poor, in particular children. Safety nets and systems for income protection may also, up to a point, be conducive to economic efficiency, since they may enhance political and social stability (Alesina and Rodrik 1994). But, in particular, we have learned over the years that highly selective social policies can make a big difference in the living conditions among the poorest sections of a society, also at a given level of per capita GDP (Sen 1983).

I argued above that it is mainly the European experience of social policies before World War II, and even before World War I, that should be of interest for social policies in today's developing countries. For the more affluent ones, however, there are also lessons to be learned from the contemporary experience of social policies in developed countries. For other developing countries, the European experience after World War II is probably of interest mainly for contemporary *discussions* of social policies far ahead in the future. The latter observation is of some importance since it often takes a long time before social policy arrangements are in place and functioning properly. An extreme example is funded social insurance systems, including so-called provident funds à la Malaysia and Singapore, since such systems mature very slowly. However, the most important message of the paper for developing countries is probably to avoid destroying existing informal systems. Empirical research suggests that these risks are real (Townsend 1994, Udry 1994).

I will organize my discussion as a “sightseeing tour” in the welfare landscape, following the individual from the womb (and hence not just from the cradle) to the tomb.<sup>1</sup>

## 2 Childhood

Before World War II, the family and other relatives were in charge of most child care in Europe, though high- and middle-class families also hired helpers (usually girls) in the market. The main example of government intervention was mandatory and subsidized primary education. After World War II, three additional government interventions were launched, or greatly expanded: prenatal care, income transfers (or tax deductions) to families with children and, in some countries, also subsidized child

care outside the family either in institutions (kindergarten) or in the homes of others (family daycare).

It is generally agreed that the sharp drop in birth rates during the last two decades threatens the financial viability of various welfare-state arrangements in the long run. An obvious policy response would be to stimulate child bearing by redistributing income to families with children, in particular those with many children. Somewhat surprisingly, this has, so far, not occurred to any large extent, perhaps because families with children are today a highly heterogeneous minority among voters.

There are, however, at least two arguments for more interventionist policy measures in the case of families with children. First, there is a second-best argument to subsidize child care outside the family, because of the existence of distortionary taxes favoring tax-free household work at the expense of taxed work in the labor market. Indeed, government policies in the Nordic countries have recently followed this second-best route through strong subsidies of child care outside the family, which is one important explanation for the high labor force participation of women in these countries.

The other argument for government intervention in the lives of families with small children is, of course, that schooling has important implications for economic efficiency and the future distribution of factor income. It is controversial whether the same argument is relevant for child care of preschool children. In the case of poor families with little education, in particular families with severe social problems, it is, however, widely believed that child care outside the family enhances human capital formation and hence the future factor income of such children. This, of course, is the traditional “head-start” argument.

Is any of this relevant for developing countries? The fertility problem is, of course, usually the reverse of the European one; about 40 per cent of the population in many developing countries are children. It is, however, hazardous (to say the least) to use this observation as an argument for turning the policy recommendation for Europe upside down for developing countries, hence recommending redistributions of income to the disadvantage of families with (many) children! We probably have to rely on

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<sup>1</sup>For a more detailed account of the role of welfare state arrangements over the individual's life cycle, though without discussion of the lessons for developing countries, see Lindbeck (2002).



traditional birth control policies and compulsory education to convince families in developing countries to restrict their number of children.

As in Europe before World War II, it is natural to expect that child care in developing countries, for a long time to come, will be pursued by the family and other relatives—combined with privately hired helpers in the case of high- and middle-class families. The most urgent policy interventions in child raising in developing countries must be improved nutrition, fights against infective diseases for pregnant woman and small children, and primary education. The relevant methods are commonplace: information about high-nutrition food intake, subsidies of such food for the poorest section of the population, obstetric care, clean water, sanitation, immunization, and subsidized compulsory primary education. Indeed, studies in medicine and biodemography have shown the importance of these factors for the physical and intellectual development of children (Behrman 1993, Scrimshaw 1996, United Nations 1997). In particular, the *interaction* between infectious diseases and malnutrition for children has turned out to be highly damaging; deficiencies in these respects are even transmitted to grandchildren. Usually, such policies are not very expensive as compared to many other types of government spending, for example infrastructure investment and military spending. It is also an area where technical and economic assistance from the outside world may be particularly useful. The head-start argument for childcare outside the biological family is probably relevant mainly for orphans and street children in developing countries.

What about education? In the poorest developing countries, there are both efficiency and distributional reasons to concentrate educational resources on primary schooling, as was the case in Europe during the first decades of the 20<sup>th</sup> century. There is, however, also an emerging consensus that a number of developing countries, for instance in Southeast Asia and Latin America, have reached a level of development where it is appropriate to allocate more resources to secondary and tertiary education. European experiences during the 20<sup>th</sup> century suggest that it then makes sense to put a strong emphasis on a *combination* of theoretical and vocational training – along the lines of the apprenticeship systems in Austria, Germany, and Switzerland. These countries have been successful both in creating a skillful labor force, at least in manufacturing, and in keeping down the level of youth unemployment.

### 3 Income and job security during working age

Only very few policy interventions directly designed to enhance income security and job security existed in Europe before the 1930s; modest unemployment benefits and limited public works programs during depressions being the main exceptions. Two reasonable explanations are perhaps that the main beneficiaries of such policies had little political power and that macroeconomic theories for rationalizing such policies did not exist before the “Keynesian revolution.”

By contrast, macroeconomic policies have dominated the political agenda in Europe after World War II. Such policies were also quite successful for a while in the sense that the macroeconomic performance in Europe was excellent from the economic recovery during the early 1950s to the mid-1970s. The subsequent situation may be characterized as a continuation of good income security combined with dismal employment performance and hence, deteriorating job security for part of the labor force. An appropriate policy package to improve employment performance would have to include not only measures strengthening the attractiveness of *outsiders* in the labor market and activating their job search, but also measures reducing the market powers of *insiders* (Lindbeck 1996).

What are the lessons, if any, for developing countries from the experience of employment policies and income protection in Europe? In most developing countries, unemployment benefits hardly exist, simply because some 60-80 percent of the population are in informal sectors (largely agriculture). In some of the more affluent developing countries, certain unemployment benefits do exist, but these are usually neither comprehensive nor generous. In some of the most advanced developing countries, including some countries in East Asia, there is, however, a quite detailed labor market legislation, including both minimum wages and job security legislation. But the implementation of the laws is usually weak or even nonexistent, which is, of course, a disadvantage for employees who would keep their jobs also with stricter implementation. However, poor implementation is an advantage for workers who would not have been hired if minimum wages and job security legislation had been strictly enforced.

As a result of all this, European-type insider-outsider division has largely been avoided in developing countries, and highly persistent unemployment after negative macroeconomic shocks do not seem to be prevalent. There is, instead, often considerable segmentation between privileged employees in the public sector, and in some cases also in large firms, on the one hand, and less privileged employees in smaller firms, on the other hand.

Moreover, some of the more affluent developing countries seem to be strongly exposed to negative macroeconomic shocks. This problem can probably be mitigated to some extent by floating exchange rates or, in some case, by membership in a large monetary union where the country's trade is concentrated. Another macroeconomic problem is that both financial institutions and production firms have often neglected their balance sheets, which appears in low equity capital and much short-term borrowing (often also in the form of uncovered loans in foreign currencies). I understand this to have been an important factor behind the financial crisis in East Asia in the late 1990s. Tougher authorities in the field of financial inspection are thus called for. In view of the severe social problems in connection with recurring macroeconomic crises in developing countries, the first, and perhaps most important, line of defense for job and income security must be good macroeconomic institutions, well-consolidated firms, and a reasonably good macroeconomic policy, including an appropriate exchange rate system.

Sooner or later, the population in developing countries will certainly demand a second line of defense, in the form of income protection. It is well known that systems of unemployment insurance do not easily spontaneously emerge via voluntary market transactions due to problems of adverse selection. Either the state or unions must intervene to create comprehensive unemployment benefit systems. It is then, of course, important to realize that the generosity and the duration for the benefits must be kept within certain bounds to mitigate moral hazard problems.

In countries with a particularly low per capita income and quite a small formal production sector, ethical considerations probably point to a safety net solution, rather than comprehensive unemployment insurance, designed to provide income protection in proportion to previous income. The purpose would be to secure elementary entitlements such as food, shelter, clothing, and basic health. Such safety nets could, of course, operate by quite different methods: public work programs; subsidized work in the private sector for unemployed workers; needs-based cash transfers ("social

assistance” or “welfare”) to poor people in general; selective transfers in kind (food programs such as food stamps); or subsidies to basic consumption. Administrative feasibility, including precision targeting, is presumably a crucial aspect in the choice of method.

The administrative difficulties in running such programs in developing countries are accentuated by the problem of knowing when the family is able and willing to provide income security to its members and when this is not the case. There may be some experiences from Southern Europe, for example Italy, on how to handle, or *not* handle, safety nets in societies with weak government administration and frequent cohabitation of parents and adult children.

Moreover, considering the dominating role of agriculture in most developing countries, crop insurance programs are often more important than unemployment insurance. Local, so-called “micro- and area-based”, protection for small farmers is another example of income protection programs that should perhaps be relied on to a larger extent today and in the near future.

#### **4 Sick-pay insurance and health care**

In Europe before World War II, personal savings, support from relatives and friends, and individual insurance schemes dominated as methods for mitigating economic setbacks in connection with health problems. Mandatory sick-pay insurance, usually administrated by government agencies, is basically a post World War II phenomenon. Since these systems are quite generous today, with replacement rates often in the interval of 70-100 percent, governments in Europe have no doubt succeeded in reallocating income to periods when the individual is temporarily sick, and hence to protect consumption during such periods. In a considerable part of Europe, sick-pay benefits, like unemployment benefits, are, however, tied to previous earnings, which favors individuals with stable employment. This means that the insider-outsider division of the labor market is transmitted to periods of bad health.

In several European countries, the sick-pay insurance systems have recently run into serious financial difficulties. One reason is moral hazard, for instance, when an

individual calls sick when feeling tired on a Monday morning. The consequences of moral hazard may be accentuated by receding social norms against exploiting the systems, when individuals observe that others do this. To the extent that these factors explain the rising costs of sick-pay insurance, more waiting days, coinsurance, and stricter administration of the benefit system would be rational policy responses.

In some countries, including Sweden, higher costs for sick-pay insurance are, however, more related to long-term than to short-term sick leave. “Double work” by women is probably a reason, since they still do the bulk of household work, including child care in the home, simultaneously with work in the labor market. In this sense, women have paid a high psychological price for their increased labor market participation. There is also some speculation in the general discussion to the effect that reorganization of work, with increased requirements of efficiency and individual responsibility, has contributed to the stress at work.

If these are important explanations, the problems might be mitigated *both* by improvements in the work environment *and* by a greater responsibility for household work, including child care, among men. The first may be achieved by experience-rated insurance fees for firms (higher fees for firms with many sick days). It is more difficult to design policies that shift household work from women to men, since this would require that the government intervene in the lives of families. Such policies, however, already exist to some extent in Denmark and Sweden, since men are offered nontransferable rights to stay at home to take care of small children, without much loss of income.

What about developing countries? In most of these, sick leave is basically financed as in Europe during the first decades of the 20<sup>th</sup> century, i.e., via relatives and civil society. In countries with more formal systems of health insurance, i.e., mainly the most affluent among developing countries, these systems are usually highly fragmented, with separate arrangements for different industries, professions and firms. If more elaborate sick-pay insurances are created in developing countries in the future, the European experience illustrates the importance of watching out for moral hazard and changes in social norms. For that reason, it is important to keep the generosity of the system within bounds, and make the administrative controls tight, not least to prevent physicians from being overly generous in certifying the needs for sick leave.

What, then, is the experience of *health care services* in Europe? In general terms, the basic problem is how to combine insurance, incentives, and freedom of choice. All health care systems are today exposed to serious cost problems, since the “third party pays.” *Insurance schemes*, in particular when based on cost-plus financing, tend to generate particularly rapid increases in costs, which is strikingly illustrated by the experience in Germany and the United States. Canada has succeeded better in containing costs in its health care insurance systems by relying on fixed budgets for health providers and price control of services. *Tax-financed* health services of the UK National Health Service (NHS) type have typically been better at containing health care costs. But this has been achieved by strict rationing, i.e., queues and waiting lists (which also is a problem in Canada), and high stress levels at work for the personnel.

Are there any lessons for developing countries from health care in developed countries? Most well informed observers probably agree that it makes sense for developing countries to emphasize fights against infectious diseases and malnutrition, not least for pregnant women and small children. This may mean that comprehensive treatments of heart disease, cancer, and other ailments characteristic of a rich and aging population, would have to be postponed. Concretely, this means information and subsidies in the field of sanitation and primary health care and probably also information about the importance of a healthy life style, including less smoking. The surveillance of public and private health care units, with very uneven qualities, is also of potential importance. In a somewhat longer perspective, there are also strong cases for mandatory health insurance for “catastrophic health care”, co-payments, and the mobilization of more resources for health care in the private sector. In many countries, it is also important to increase the salaries of doctors and nurses.

Apart from this, it is important to allow and stimulate *experimentation*, which requires considerable freedom of entry of nongovernment health providers—for nonprofit as well as profit organizations. I then assume that it is better to allow decentralized experimentation, rather than keep existing systems intact or, as often occurs, have the government conduct full scale experiments for a whole country. It is also important to avoid destroying whatever nongovernment networks exist via families and civil society.<sup>2</sup>

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<sup>2</sup> The role of such networks in developing countries is still an “under-researched” field.

## 5 Pensions and old-age care

While mandatory pension systems in Europe have been instrumental for providing income security for the elderly, governments have played a much more modest role in the field of care for the elderly. As we know, both fields encounter serious problems today. To the extent that contemporary, and projected future, financial problems of the pension systems are caused by low birth rates in the past, conceivable remedies would be to boost nativity (with considerable time-lag before the size of the labor force is influenced) and encourage the immigration of young individuals of working age. Unfortunately, it is not obvious that governments can do much about birth rates (except perhaps provide good child care outside the family), and there may be “social limits” to immigration because of the risks of ethnical tensions in the countries of immigration. To the extent that financial problems for pension systems are related to a higher longevity of individuals after retirement, raising the statutory pension age and removing subsidies to early retirement are instead natural remedies. But to avoid heavy unemployment among the elderly in connection with later retirement, it is also important to allow greater flexibility in relative wages (for workers of different ages) and increase the possibilities for retirees to individually choose the length of their work week.

It is today also increasingly understood in Europe that PAYGO (“pay-as-you-go”) pension systems create disincentive problems for work via implicit tax wedges. The reason is, of course, that the link between the contributions and the subsequent pension benefits for the individual is usually quite weak. An obvious way of mitigating this incentive problem is to tighten the link, hence making the pension systems more actuarial, or “quasi-actuarial” (since the return on mandatory pension saving would be lower than the return in financial markets). There is also a case for a *partial* shift to a funded pension system. The individual then would be able to enjoy a more diversified portfolio of pension claims than in *either* a pure PAYGO system, where the (risky) return depends on the growth rate of the tax base, *or* a pure funded system where the (risky) return depends on developments in financial markets. The reason is, of course, that these two types of returns are not fully correlated, in particular if the pension funds invest in international capital markets.

What is the relevance of all this for the financing of retirement in developing countries? In most such countries, informal systems, in particular via relatives, are likely to dominate for a long time to come. Sooner or later, there will, however, be a strong ethical case for government intervention to mitigate poverty among the elderly—an application of the safety net idea to the retirement period. A *basic* pension in the form of a lump sum payment, equal for all elderly, or means-tested pension benefits, are then obvious alternatives. This corresponds to the World Bank's (1993) recommendation for a "universal first-tier pension." An additional advantage of such a system, in principle, is that it is rather equitable if financed by tax payments that increase with income. But in many developing countries, only a few percent of the population pay income taxes, or can be exposed to payroll taxes, which, of course, means that the financing would be a serious administrative obstacle.

In the long run, the expanding middle class will, however, hardly be satisfied with either a basic pension or means-tested pension benefits. This group is likely to ask for income protection in some proportion to previous income, as in today's developed countries, partly in response to a gradually reduced importance of transfers within families. As we know, some developing countries have already started to build up mandatory pension systems of this type: funded systems in Chile and Malaysia and some other countries in Latin America; while Korea, Philippines, and Thailand have chosen social security systems. Advocates of mandatory, funded pension systems in developed countries have often referred to the importance of boosting aggregate national saving, which is easiest if a funded system is created "from scratch." While the argument for such a boost may be important for some developing countries, it hardly has much strength in developing countries with high national saving rates, such as some countries in East Asia.

In the future, when comprehensive pension systems probably will exist in today's developing countries, the same financial problems as in today's developed countries are likely to occur. Falling fertility and increased longevity seem to be inevitable developments in the modern world, and even the fastest growing countries will sooner or later experience slower productivity growth. In the few developing countries where formal pension systems already exist, the pension age is usually quite low (relative to life expectancy). Thus, there is great room for defending, or improving, the financial position of these systems by raising the retirement age, for



instance, from 55 to 67 or even 70. Some developing countries may also find it easier than many countries in Europe to accommodate the elderly in the labor market, since they have had arrangements for work for the elderly for a long time, and since relative wages are often more flexible than in Europe. It remains to be seen whether these conditions will prevail.

Contemporary financial and organizational problems in the field of *old-age care* in developed countries are related to the demographic factors of the same type as those that have created problems for the pension system. The organizational difficulties are instead rather similar to the problems of health care: it is difficult to combine solidarity-oriented financing with production efficiency and freedom of choice. Old-age care is also hurt by Baumol's Law (Baumol 1967), which explains why costs and prices tend to increase particularly fast in the case of labor intensive services like human care. Another issue concerns the freedom of choice of services for the elderly. Such freedom is, in principle, easy to bring about in the case of service in the elderly's homes—shopping, cooking, cleaning etc.—like in child care and care for the elderly. Service checks (vouchers) are an obvious tool. Vouchers are less useful in the case of institutionalized old-age care, since the needs for medical care vary enormously among patients. Still it would certainly be possible to offer considerable freedom of choice of service institution for the elderly.

It will take some time before most developing countries encounter similar problems, not only because the population is still young, but also because the family is likely to supply care services to the elderly for a long time to come. But it may be a good idea at least to start thinking, and perhaps also experimenting, with alternative systems of care for the elderly before there is an acute need to expand formal systems in this field. In the long run, it is not likely that family members and other relatives can be relied on to service the elderly any more in today's developing countries than in Europe.

## 6 Conclusion

The experiences of social policies during the first decades of the 20<sup>th</sup> century in Europe underline the important role of informal systems for income security and personal services at low levels of economic development. It is crucial, however, that

informal systems are not destroyed when developing countries embark on more formal systems in these fields in the future. I have also emphasized that the European experience warns against the creation of social systems that are so generous that disincentives, moral hazard, and receding social norms seriously distort the national economy, including the labor market. These risks seem to be particularly important in the case of unemployment benefits, support to single mothers, sick leave, disability pensions and early retirement. If disincentives and moral hazard undermine the financial viability of government-operated systems, and these would therefore have to be cut back, many individuals may suddenly find themselves without both types of social systems.

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